UBS

UBS House View

Monthly Extended February 2024

Chief Investment Office GWM

Investment Research

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This report was prepared by UBS AG London Branch, UBS Switzerland AG, UBS AG Hong Kong Branch, UBS AG Singapore Branch and UBS Financial Services Inc.

To see our most recent forecasts, please refer to our publication called "Global forecasts "

Please see the important disclaimer at the end of the document.

This document is a snapshot view. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

Section 1

Investment views

Section 1.1

Asset class outlook

Asset class outlook

Global asset allocation

In our global strategy, we keep our preference for bonds over equities.

Within equities, we retain our preference for quality income. Our most preferred regions are emerging markets and China.

Within bonds, we prefer high grade and investment grade over high yield and emerging market credit.

Within commodities, we hold a preference for oil.

Within foreign exchange, we have a neutral stance in all major currencies, with the exception of the AUD, which we have at most preferred.

Equities

Equities rallied into the year-end amid hopes central banks will pivot to a less restrictive stance. Some consolidation from stretched levels followed in early January. Sensitivity to yields remains high, but much seems priced in.

We believe the US economy, while slowing, is resilient enough to achieve a soft landing. Led by AI, earnings are likely to recover next year, but the consensus view already appears quite optimistic.

We remain neutral on global equities and expect mid- to high-single-digit returns in 2024.

Regionally, we prefer emerging markets (including China) over the UK. Also, we hold a preference for quality income.

Bonds

We are most preferred on the higher-quality segments of fixed income, given the all-in yields on offer and as central banks transition from a rate hiking to cutting cycle. Specifically, we maintain a preference for high grade (government) and investment grade bonds, and are neutral on high yield and emerging market credit.

The tightening of lending standards and higher official policy rates over the last two years will continue to transmit into the real economy and apply downward pressure on growth and inflation, and by derivation nominal interest rates. This is a positive driver for the performance of high-quality bonds. The prospects of rate cuts has been priced into market expectations and hence resulted in some easing of financial conditions already.

Foreign exchange

The US dollar's downside was tested and successfully supported at the turn of the year. Our broad forecast range for EURUSD between 1.05 and 1.10 remains intact. Our most preferred currency with upside potential against the USD is the Australian dollar.

The USD slump in November also boosted emerging market currencies, and those linked to the euro were among the best performers. However, we caution against extrapolating from the last two months' experience, as markets have pushed expectations for Fed rate cuts quite far, in our view.

In the short term, we like to use options for yield pickup when it comes to the USD, while investors should consider potential gainers from higher energy prices (AUD, Norwegian krone, or Canadian dollar).

Commodities

Our return outlook for commodities remains positive, and we expect broadly diversified commodity indexes to appreciate by mid- to high-single-digit rates, with a total return of around 10% for the full year.

All commodity sectors should contribute to the likely decent performance. As spot moves are unlikely to be synchronous, broad asset class exposure is advised. This should come with an expected volatility of only 10–15% in 2024.

The underlying risk skew to our view looks largely balanced. While the macroeconomic picture suggests downside risks, structural demand drivers, supply-related risks, and low inventories will likely act as counterweights.

We keep our preference for oil and continue to recommend actively managing commodity exposure.

Section 1.2

Risk scenarios

Key scenarios for 2024

	Upside: Goldilocks	Base case: Soft landing	Downside: Hard landing	*Things to watch*
Probability	*20%*	*60%*	*20%*	
Market path	**Bonds slightly up, equities up** Equity markets and other risk assets rally as bonds remain supported by lower policy rates.	**Bonds up, equities slightly up** Equity markets remain volatile but continue to grind higher amid slow but stable growth, falling inflation, and normalizing financial conditions.	**Bonds up, equities sharply down** Global equities post double-digit losses and credit spreads widen. Safe-haven assets such as high-quality bonds, gold, the Swiss franc, and the Japanese yen, appreciate.	
Economic growth	The US continues to grow at or above the trend rate of about 2% as labor markets, household balance sheets, and corporate earnings prove resilient. China opts for large-scale fiscal stimulus. European growth improves.	The US economy slows slightly below trend growth over the next 12 months. Other Western economies continue to decelerate and experience subtrend or negative growth. China announces targeted measures to support economic activity.	Falls sharply on a global scale toward mid-2024 owing to the delayed impact of monetary tightening. Rising fiscal deficit and Treasury supply in the US push bond yields higher in the near term, raising the likelihood of a recession in 2024. China continues to decelerate amid underwhelming fiscal support.	*US, China: PMI data* *US, Europe: Industrial prod.* *Global: Consumer spending* *US: Housing starts* *US: Savings rates, depletion* *US, Europe: Delinquency ratios* *Europe: gas prices*
Inflation	Reaches central bank targets earlier than expected.	Continues to slow in the US and in Europe, normalizing by 2H24.	Falls quickly as demand for goods and services collapses.	*Global: Oil price* *US: CPI and PCE inflation* *US: ISM prices-paid subindex* *US: Average hourly earnings* *US: Chg in nonfarm payrolls* *US: JOLTS openings and hires* *Eurozone: HICP inflation*
Central banks	Cut policy rates in line with market expectations.	Start cutting policy rates by mid-2024 as inflation normalizes. The Fed cuts rates by 100bps.	Cut interest rates after seeing evidence of a deep recession. The Fed cuts rates down to 1–1.25%.	
Financial conditions	Ease as a better growth-inflation mix is priced in.	Ease gradually amid building expectations of upcoming monetary easing.	Tighten dramatically, causing stress in the financial system and increasing the risk of systemic events.	*Global financial conditions* *Bank lending surveys*
Geopolitics	The Middle East crisis de-escalates. The war in Ukraine also de-escalates, e.g., via a ceasefire agreement. Progress is made in bilateral relations between the US and China.	The Middle East crisis results in a contained regional confrontation. The war in Ukraine drags on as ceasefire negotiations remain elusive. The US-China strategic rivalry continues.	The Israel-Hamas war turns into a regional conflict with potential for greater disruption to oil supply. The war in Ukraine escalates, and US-China tensions intensify.	*Middle East crisis and oil supply* *Territorial gains by Russia* *Weapons shipments to Ukraine* *US sanctions on Chinese companies*

Asset class targets - December 2024

Key targets for December 2024	spot*	Upside	Base case	Downside
MSCI AC World	859	970 (+13%)	910 (+6%)	700 (–18%)
S&P 500	4,739	5,300 (+12%)	5,000 (+6%)	3,700 (–22%)
EuroStoxx 50	4,403	5,200 (+18%)	4,700 (+7%)	3,800 (–14%)
SMI	11,149	12,300 (+10%)	11,640 (+4%)	9,800 (–12%)
MSCI EM	958	1,200 (+25%)	1,080 (+13%)	820 (–14%)
Fed funds rate (upper bound)	5.5%	4%	4.5%	1.25%
US 10y Treasury yield	4.1%	4%	3.5%	2.5%
US high yield spread**	365bps	370bps	450bps	850bps
Euro high yield spread**	391bps	370bps	450bps	850bps
US IG spread**	92bps	80bps	120bps	200bps
Euro IG spread**	140bps	110bps	150bps	220bps
EURUSD	1.09	1.15 (+6%)	1.12 (+3%)	1.03 (–5%)
Commodities (CMCI Composite)	1,726	2,000 (+16%)	1,850 (+7%)	1,550 (–10%)
Gold***	USD 2,007/oz	USD 2,000/oz (0%)	USD 2,250/oz (+12%)	USD 2,500/oz (+25%)

* Spot prices as of market close of 17 January 2024. Developed market constituents of the MSCI All Country (AC) World Index display in the local currency. The MSCI EM index displays in US dollar. Values in brackets are expected percentage changes from the quoted spot levels. Dividends, share buybacks, and other sources of carry are not included.

** During periods of market stress, credit bid-offer spreads tend to widen and result in larger ranges.

*** Gold is a safe-haven asset whose price tends to rise when risk assets, such as equities, fall, and vice versa.

Note: Asset class targets above refer to the respective macro scenarios. Individual asset prices can be influenced by factors not reflected in the macro scenarios.

Section 1.3

Asset class preferences and themes

Global asset class preferences

	Least preferred		Most preferred
Liquidity		=	
Equities		=	
Quality income			+
Small caps		=	
United States		=	
Eurozone		=	
Switzerland		=	
Emerging markets			+
Japan		=	
United Kingdom	−		
Bonds			+
High grade			+
Investment grade			+
High yield		=	
Emerging markets		=	

	Least preferred		Most preferred
Commodities		=	
Oil			+
Gold		=	
Foreign exchange			
USD		=	
EUR		=	
JPY		=	
GBP		=	
CHF		=	
AUD			+

Note: The global asset class preferences reflect the high-level UBS House View. The tactical asset allocation (TAA) positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them. Also, these preferences may vary in different regions for various reasons such as currency considerations.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Asia ex-Japan asset class preferences

	Least preferred		Most preferred
Equities			
Asia ex-Japan		=	
China			+
Hong Kong		=	
India			+
Indonesia		= →	+
South Korea		=	
Malaysia	–	← =	
Philippines		=	
Singapore	–		
Taiwan		=	
Thailand		=	
Bonds			
Asian investment grade bonds		=	
Asian high yield bonds		=	
Chinese government bonds		=	

Note: The Asia ex-Japan asset class preferences reflect the high-level UBS House View. The TAA positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

US asset class preferences

	Least preferred		Most preferred
Cash		=	
Fixed Income			+
US Gov't FI		=	
US Gov't Short		=	
US Gov't Intermediate		=	
US Gov't Long		=	
TIPS			+
US Agency MBS			+
US Municipal		=	
US IG Corp FI			+
US HY Corp FI		=	
Senior Loans		=	
Preferreds		=	
CMBS		= →	+
EM Hard Currency FI		=	
EM Local Currency FI		=	

	Least preferred		Most preferred
Equity		=	
US Equity		=	
US Large Cap	−		
US Growth Equity		=	
US Value Equity		=	
US Mid Cap		=	
US Small Cap			+
Int'l Developed Markets		=	
UK	−		
Eurozone		=	
Japan		=	
Australia		=	
Emerging Markets			+
Other			
Commodities		=	
Gold		=	
Oil			+
MLPs		=	
US REITs		=	

Note: The US asset class preferences reflect the high-level UBS House View. The TAA positioning of our different investment strategies may differ from this view because our strategies seek specific investment objectives and can frequently adjust portfolio allocation to achieve them.

Least preferred
We expect this asset class to deliver the least attractive risk-adjusted returns over the next 12 months within our asset class universe.

Most preferred
We expect this asset class to deliver the most attractive risk-adjusted returns over the next 12 months within our asset class universe.

Global and regional sector preferences

Sectors	LP	US	MP	LP	Eurozone	MP
Communication services		=		−		
Consumer discretionary		=				+
Consumer staples			+			+
Energy			+		=	
Financials		=			=	
Healthcare		=		−		
Industrials		=		−		
Information technology			+		=	
Materials	− →	=				+
Real estate	−				=	
Utilities	−				=	

Least preferred (LP)
We expect this sector to deliver the least attractive risk-adjusted returns over the next 12 months within our sector universe.

Most preferred (MP)
We expect this sector to deliver the most attractive risk-adjusted returns over the next 12 months within our sector universe.

Messages in Focus

Manage liquidity*

We believe investors should limit their overall cash balances in the year ahead. Interest rates are likely to fall in 2024, potentially sharply. This will reduce the return of cash and increase reinvestment risks. Beyond cash and money market funds, investors should diversify their liquidity strategy with a combination of fixed term deposits, bond ladders, and structured investment strategies to cover expected portfolio withdrawals over the next five years.

Fixed term deposits
Bond ladders
Structured investment strategies with capital preservation features

Source of funds
- Cash
- Maturing investments

Buy quality

We expect positive overall returns for both equities and bonds in the year ahead. But within each asset class, we believe investors should focus on quality. In fixed income, quality bonds (including sustainable and MDB bonds) offer attractive yields and should deliver capital appreciation if interest rate expectations decline, as we expect. In equities, quality companies with strong balance sheets and high profitability, including those in the technology sector and within ESG leaders, should be best positioned to generate earnings in an environment of weaker growth.

Quality stocks (including US IT)
Quality bonds (HG and IG)
Sustainable equivalents (ESG leader equities, sustainable bonds, MDB bonds)

Source of funds
- Cash
- Excess EM / high yield bonds
- Excess equity exposure

Trade the range in currencies and commodities

We expect the US dollar to stay stable around current levels over the coming months, though USD weakness may emerge later in the year as US rates fall. This makes selling USD upside for yield pickup attractive. Meanwhile, we expect oil prices to fluctuate in the USD 80–90/bbl range in 2024, creating opportunities for investors to sell downside risks or navigate the range.

Sell USD upside
Range-trading in EUR, CHF, GBP, and CNY
Trade the range in crude oil

Source of funds
- Cash
- Maturing investments
- Available collateral (for OTC range trading strategies)

Diversify with alternative credit

We expect high global debt balances to contribute to elevated price and spread volatility, driving investors to seek ways to benefit from dispersion. This is a supportive backdrop for various credit strategies, including credit arbitrage and distressed debt. We also see opportunities in convertible arbitrage, a strategy which we expect to see more opportunities as companies refinance maturing debt.

Credit arbitrage
Distressed debt
Convertible arbitrage

Source of funds
- Cash
- Maturing investments

Anticipate a "goldilocks" scenario

In our upside scenario, preemptive Fed interest rate cuts alongside still-robust growth and falling inflation drive strong performance in equity and bond markets. Investors should therefore seek to position in parts of the market that can capture more upside in a "goldilocks" scenario, while also faring well in a base case scenario. For example, we would expect US and European small-caps, Swiss mid-caps, and emerging market equities, to be particular beneficiaries, given their interest rate sensitivity and low valuations. We would also expect them to fare well in our base case scenario.

US small-caps
European small- and mid-caps
Swiss mid-caps
ESG engagement strategies
Emerging markets (incl. India)

Source of funds
- Cash
- Maturing investments

Hedge market risks

In our downside scenario, weaker economic growth would lead to significant weakness in global equity markets. The good news is that implied equity market volatility has fallen to multi-year lows, making this an attractive time to consider capital preservation strategies to hedge against market risks. We also think gold would be a major beneficiary of lower interest rates and heightened risk aversion in a downside scenario, and we also see upside for gold in our base case. Meanwhile, we would expect macro hedge funds, which have historically delivered consistent performance in times of market turbulence, to act as an effective portfolio diversifier.

Defensive structured investment strategies
Gold
Oil and energy stocks
Macro and multistrategy hedge funds

Source of funds
- Cash
- Excess equity exposure

Pick leaders from disruption

We expect some of the highest returns in equity markets over the decade ahead to come from those companies that can harness new technologies to grow markets, dislodge incumbents, or slash costs. Successfully identifying these "leaders from disruption" is critical to boosting long-term portfolio potential. We expect the decade ahead to see a wave of disruption rippling across industries, from technology to energy to healthcare.

Tech disruption
Energy disruption (greentech, clean air and carbon reduction, energy efficiency, EVs)
Healthcare disruption (obesity, medical devices)

Source of funds
- Cash
- Maturing investments

Capture growth with private markets

A new world will see significant investments in healthcare, digitalization, and energy. But high government debt levels mean public funding for innovation is likely to be constrained. Private market managers, with their ability to provide equity or debt capital to companies at different lifecycle stages, have a key role to play. Private markets offer attractive return potential and differentiated access to the real economy, in exchange for lower liquidity. They can also be an effective vehicle for investors focused on driving positive change through impact and sustainability.

Secondaries
Value and middle market buyout
Thematic growth
Private infrastructure
Private credit

Source of funds
- Excess bonds / equities
- Concentrated equities

Analysts: Kiran Ganesh, Sagar Khandelwal, Wayne Gordon, Jason Draho, Michael Gourd

*Time frames may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

Key investment ideas by asset class

	We like	Source of funds
Equities	• Quality stocks (incl. US IT) • Emerging market equities incl. China, India, Indonesia • US small-caps, European small- and mid-caps, Swiss mid-caps • ESG engagement strategies • Tech disruption • Energy disruption (greentech, clean air and carbon reduction, energy efficiency, EVs) • Healthcare disruption (obesity, medical devices)	CIO least preferred equities, excess cash
Bonds	• Quality bonds (investment grade and high grade) • Sustainable bonds, MDB bonds • Fixed term deposits • Bond ladders	Excess cash, excess EM and HY bonds
Foreign exchange	• AUD • Range-trading in EUR, CHF, GBP, and CNY	Upside in USD
Commodities	• Active commodity exposure • Oil	Excess cash, excess equity exposure
Hedge funds, private markets	• Hedge funds (credit arbitrage, distressed debt, convertible arbitrage) • Private markets (value and middle market buyout, secondaries, private infrastructure, thematic growth, private credit)	Excess bonds and equities, concentrated equities, maturing investments, cash

Section 2

Macro economic outlook

Global economy – Disinflation forces continue to operate

Base case (60%)

Growth

Consumers are benefiting from real income gains as consumer price inflation continues to subside. However, improvements in real wages are taking the place of savings and credit to support consumption, so the overall effect is likely to be that consumer spending is sustained, rather than boosted. The changing structure of consumption continues to favor spending in services relative to goods. Excess supply in some goods-producing sectors is a possibility.

Inflation

Price index details continue to signal disinflation as the dominant narrative. The evidence of consumer rebellion against profit-led inflation is apparent in several economies. While the pace of disinflation will inevitably slow from 2023, inflation is still likely to move back to pre-pandemic ranges. Policymakers' concerns about inflation "stickiness" are receding in the absence of any evidence supporting such a view.

Positive case (20%)

Real wage growth is enhanced by a faster decline in inflation, and consumers respond with more support to the economy. The low inflation rate still allows some moderation of interest rates (as central banks seek to avoid rising real interest rates). Unemployment rates remain low as sales volumes take over from margin expansion in driving corporate profits, and strong household balance sheets support demand.

Negative case (20%)

A more rapid tightening of credit standards and higher cost of borrowing for existing debtors lead to a sharper slowdown in consumer demand as spending power is eroded. Consumer concerns about the cost of credit slows borrowing for both middle-income and lower-income groups. Fear of unemployment starts to increase, leading to a rise in precautionary spending. This compounds the risks to growth.

The model for transitory inflation

Consumer durable goods price inflation

Source: Haver, UBS, as of 15 January 2024

People need to work more than one job, but can find the work

US share of employed workers with more than one job

Source: Haver, UBS, as of 15 January 2024

US economy – On a path toward a soft landing

Base case (60%)

Growth

Growth has remained above-trend since 3Q22. However, other data have been less impressive, including the ISM PMIs, which point toward much more modest growth. Payroll growth has been on a slowing trend, and consumers have been using their credit cards to help sustain spending. High borrowing costs are weighing on both consumers and businesses. Our base case remains a soft landing, but the Fed will likely have to start trimming rates in 2024 to avoid a recession.

Inflation

Core inflation has surprised to the downside in recent months. Supply chain issues have mostly been resolved, helping to bring goods inflation toward zero. However, services inflation is still elevated, led by shelter, and wage growth is too high for the Fed to sustainably hit its 2% target over the medium term. Additional softening of the labor market will be needed for the Fed to declare victory over inflation.

Positive case (20%)

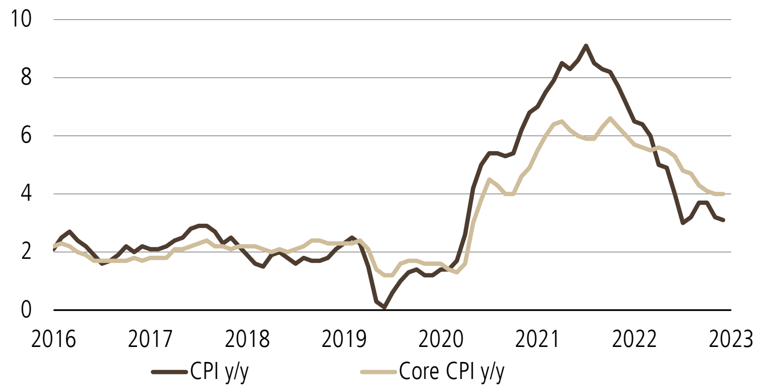
Better labor supply allows businesses to fill their open job positions. Wage growth slows to a more moderate pace, and energy prices remain stable, helping to bring inflation down. Lower inflation helps real disposable incomes to continue rising, leading to sustained consumption growth. The Fed sees enough progress toward its mandates to start trimming rates in 1H24 while growth stays healthy.

Negative case (20%)

Households use up their excess savings, while the resumption of student loan payments leaves less money for spending. Seeing weakening consumer demand, businesses increase the pace of layoffs, and this pushes the economy into a recession. A spike in energy prices could lead to stagflation, but otherwise inflation should fall quickly, allowing the Fed to cut rates aggressively and helping to prevent a severe downtown.

Core inflation continues to trend lower

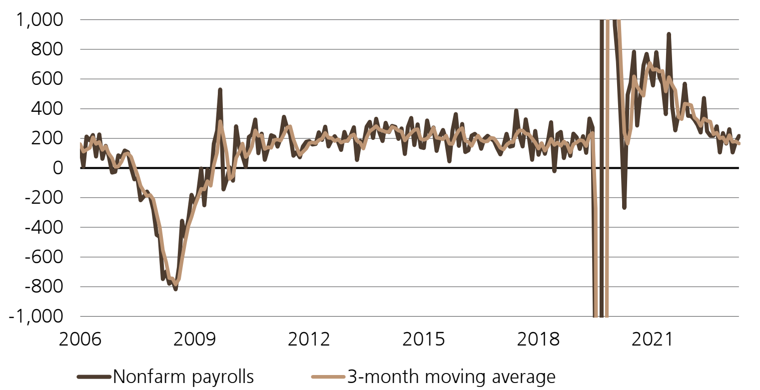
Headline and core CPI inflation, y/y change in %



Source: Bloomberg, UBS, as of 12 January 2024

Payrolls growing at a more moderate pace

Nonfarm payrolls, monthly change in thousands



Source: Bloomberg, UBS, as of 12 January 2024

Eurozone economy – Waiting for improvement

Base case (60%)

Growth

2023 ended with surveys of business sentiment showing further stabilization, with some signs of mild improvement but remaining at low levels. Likewise, hard data remain weak. The economy likely entered a shallow recession in 2H23, and we expect it to remain on a sideways trend in the coming months. We expect activity to experience a modest pickup later in the year as real incomes improve and the drag from tight monetary policy eases.

Inflation

Headline inflation inched up in December due to base comparison effects in energy, but core inflation continued to ease. Some volatility in headline inflation could persist early in 2024 as governments phase out remaining fiscal support measures. Still, we expect inflation to fall back to target in the coming quarters, faster than the European Central Bank projects. Along with more moderate wage growth, this should lend ECB confidence to lower interest rates, most likely starting June.

Positive case (20%)

Economic activity normalizes sooner than expected, supported by a sharp fall in inflation, a pickup in consumer sentiment, earlier-than-expected monetary policy easing, and ongoing labor market strength.

Economic growth in Asia and the US accelerates, with the latter avoiding a recession, boosting demand for Eurozone exports.

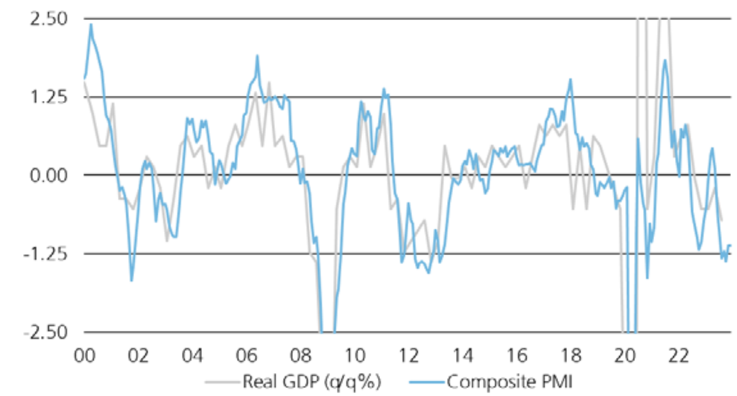
Negative case (20%)

The ECB overtightens monetary policy by placing too much weight on near-term inflation. Tighter financial conditions see demand for credit collapse further, hurting consumption and investment.

Geopolitical tensions force energy prices materially higher, leading to renewed supply-push inflation that induces a real income loss and a tighter monetary stance.

Growth likely to remain anemic as sentiment measures stabilize at a low level

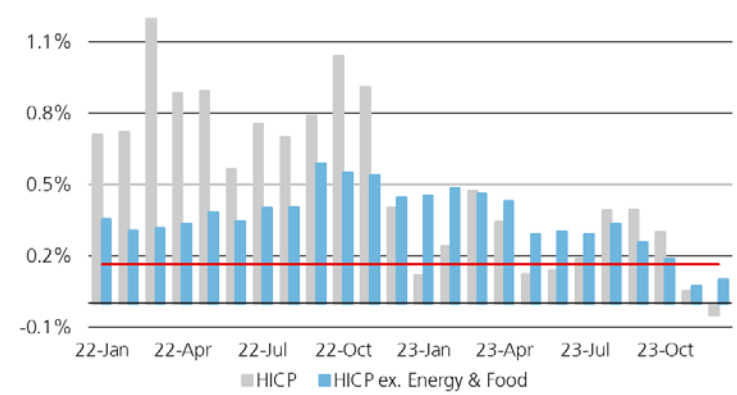
Output measures for the Eurozone (z-scores)



Source: Haver Analytics, UBS, as of 10 January 2024

Month-over-month inflation broadly consistent with ECB target

HICP m/m (3mma, SWDA)



Source: Haver Analytics, ECB, UBS, as of 10 January 2024

Swiss economy – SNB to cut three times in 2024

Base case (70%)

Growth

We expect the Swiss economy to grow at a below-average rate this year. The weakness in the Eurozone economy is weighing on manufacturing sentiment. Domestic demand is likely to stay solid and cushion the slowdown in manufacturing.

Toward the end of 2024, GDP growth should improve on the back of global sporting events. Furthermore, rate cuts from major central banks should support European growth and help Swiss exports to recover.

Inflation

Inflation in December came in at 1.7%, remaining within the Swiss National Bank's target range of 0–2%. In the months ahead, we expect inflation to stay elevated, but the risk of it exceeding 2% has come down.

Against this backdrop, we expect the SNB to cut rates three times starting June, bringing the policy rate down to 1% by the end of 2024.

Positive case (15%)

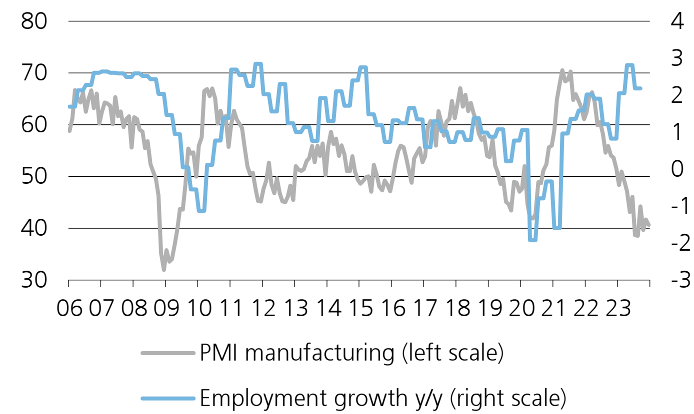
Better global growth momentum:
If the current robust growth in the US filters through to Europe and China, global GDP growth could surprise on the upside. Switzerland benefits from a stronger global backdrop and a weakening of the Swiss franc.

Negative case (15%)

US downturn pushes Switzerland into a recession:
If the global economy falls into recession, Switzerland could suffer from the slump in global export demand and a strong appreciation of the safe-haven Swiss franc.

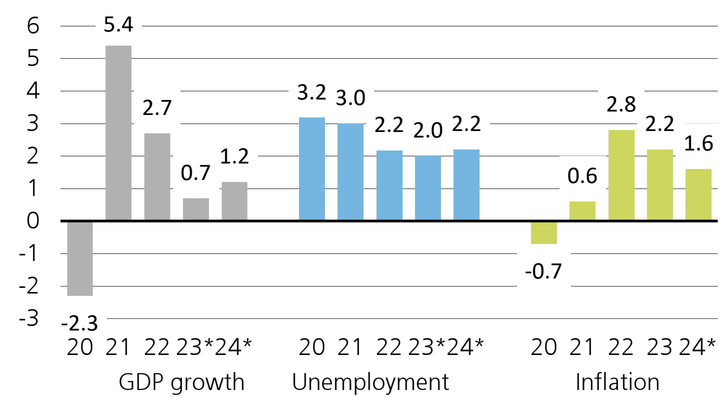
Foreign demand soft but domestic demand resilient

Swiss PMI manufacturing and employment growth (in %)



Source: Macrobond, UBS, as of 9 January 2024

Swiss forecasts (in %; *UBS forecasts)



Source: Macrobond, UBS, as of 9 January 2024

Chinese economy – Stronger stimulus needed to spur growth

Base case (70%)

Growth

China's GDP grew 5.2% in 2023, in line with the official target of "about 5%." The pace of recovery softened in December: Retail sales growth eased to 7.4% amid weaker goods sales, while investment growth remained subdued at 3%, still dragged by property despite resilient infrastructure and manufacturing.

Beijing may its keep "about 5%" target at the "Two Sessions" policy event in March. Fiscal support should step up with a roughly 3.5% deficit, alongside robust bond issuance. Monetary policy should continue to ease with more liquidity injection and cuts to bank reserve requirements and the medium-term lending facility rate. Pledged supplementary lending (PSL) could be further expanded to support urban village renovation.

Inflation

CPI inflation came in at – 0.3% in December and 0.2% for the full year. It could pick up to 0.8% in 2024. PPI deflation narrowed to –2.7% and –3% over the same period and could reverse to positive by 3Q24.

Positive case (20%)

Unconventional demand-targeted policies are announced to revive confidence.

Geopolitical risks ease as China and the US show greater willingness to communicate.

The US economy achieves a soft landing.

Negative case (10%)

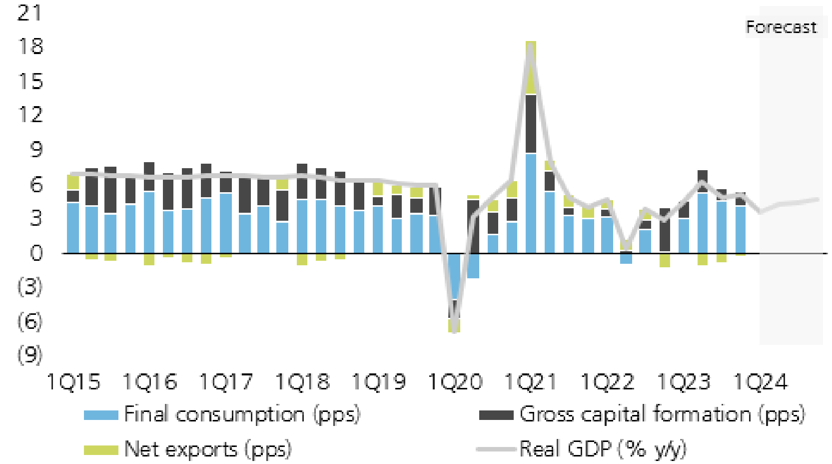
Property activity continues to deteriorate.

The US falls into a deep recession due to the lagged effect of high rates.

The US imposes much stricter restrictions on China's tech sectors.

2024 GDP growth may settle at mid-4%

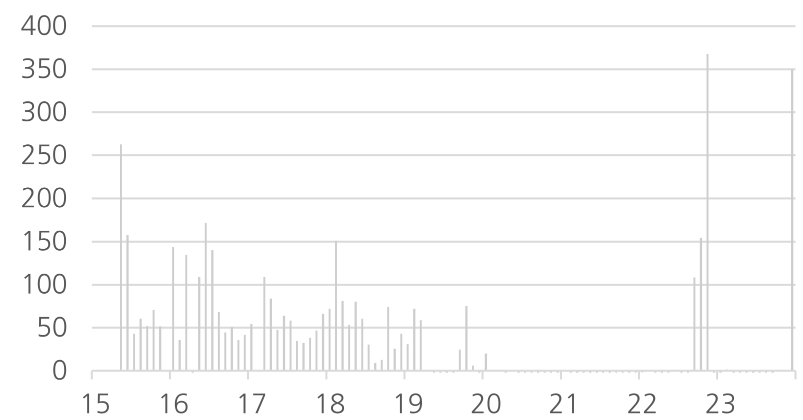
GDP growth contribution breakdown



Source: CEIC, UBS, as of January 2024

Further PSL expansion to support urban village renewal

New PSL, in CNY bn



Source: CEIC, UBS, as of January 2024

Section 3

Asset class views

Section 3.1

Summary of major asset classes

Equities

Central scenario

MSCI AC World December 2024 target: 910

We maintain a neutral view on global equities. Global equities ended 2023 strongly amid hopes central banks will pivot to a more dovish stance. Lower market rates and resilient earnings are likely to support the asset class going forward, but a lot of optimism seems to be priced in already. Against this backdrop, we maintain a neutral stance in our asset strategy and expect global equities to deliver mid- to high-single-digit returns by end-2024.

Equities remain sensitive to interest rates. With the global economy slowing and inflation rolling over, we expect lower yields going forward. Unless markets start pricing in a US recession—which is not our base case—we believe lower yields should still act as a tailwind to equity valuations for now. That said, any valuation expansion has limits, and earnings support would eventually be needed for gains to be sustained.

The earnings outlook has improved. The latest economic data support our base case that a soft landing is the most likely outcome. Against this backdrop, 2023 earnings likely narrowly avoided a contraction, and we expect a rebound in 2024. This recovery should be led by technology sectors, which are expected to see rising AI-linked revenues. More favorable base effects (i.e., a lower drag from the commodities and healthcare sectors) are also playing a role. That said, we find the current consensus for 2024 earnings per share (EPS) growth quite aggressive (around 10% for MSCI ACWI), which suggests the improved earnings backdrop is well priced in already. Whether companies deliver or beat this forecast will depend on their ability to defend margins, the resilience of the labor market, and the magnitude of the restocking cycle.

Valuation in line with 10-year averages. Global equities are currently trading at a 12-month forward price-to-earnings (P/E) ratio of 16.6x. This is broadly in line with their 10-year average and supports our neutral stance. That said, the equity risk premiums remain low in a historical context, especially against fixed income markets.

Tactical indicators are mixed. With the latest rebound, global equities are trading comfortably above their key moving averages, highlighting a solid price momentum picture. Investor positioning continues to rise but is still some distance away from extreme levels. However, short-term indicators such as the 30-day relative-strength index, for example, still appear stretched and point to further consolidation in the coming weeks.

Emerging market equities most preferred. Sentiment in emerging markets (EM) has been fragile amid ongoing China concerns. Challenges remain but should not mask the solid fundamentals of the region. EM and China earnings have bottomed, are being revised higher, and should grow faster than in any other major region in 2024. In addition, multiples remains attractive both in absolute and relative terms (forward P/E below 12x for EM, below 9x for China). We see value in EM equities that could be unlocked when the Fed starts its easing cycle

UK equities least preferred. We expect UK equities to rise less than their regional peers in our tactical horizon.

UK earnings contracted significantly in 2023, dragged by commodity sectors, and should show one of the weakest recoveries in 2024 among major equity markets.

CIO themes

Quality income

We see three reasons to invest in our "Global quality income" theme: 1) These stocks tend to do better during an economic slowdown; 2) they usually outperform in a market sell-off and when volatility rises; and 3) dividends are typically safer than earnings, while balance sheets remain safe and capital returns well covered. Moreover, the dividend yield of our basket is appealing at an estimated 4.1% for 2024.

Country preferences

Most preferred: Emerging markets

Least preferred: UK

Analysts: Crystal Zhao, Fabian Deriaz, Adrian Zuercher, Mark Andersen

Equities

Upside scenario

MSCI ACWI December 2024 target: 970

Inflation cools quickly and the US and European economies grow above trend: Inflationary pressures quickly dissipate, but growth turns out stronger than expected.

Geopolitical de-escalation: A ceasefire ends the war in Ukraine and between Israel and Hamas, and reduces the risk of further sanctions against Russian or Iranian commodities.

Economic growth reaccelerates: Solid economic growth in the US and emerging markets drives a sharper improvement in corporate profits.

Downside scenario

MSCI ACWI December 2024 target: 700

Inflation runs hot: Inflation surprises again on the upside and central banks are forced to hike more than expected.

Geopolitical escalation: Increased escalation between Russia and Ukraine or between Israel and Hamas leads to a further disruption of Russia's or Iran's energy supplies. Oil and natural gas prices rise sharply and remain elevated.

Economic growth shrinks sharply as a result of the lagged impact of tighter monetary policy, driving earnings growth and valuation multiples lower.

Analysts: Crystal Zhao, Adrian Zuercher, Mark Andersen, Ivan Peric

Bonds

In the last month the major event was the Fed and their communication that they were becoming more comfortable that policy rates could be lowered this year from currently restrictive levels, given the ongoing disinflation underway. This translated into a sharp pullback in bond yields across the curve as the market rapidly increased expectations for rate cuts. In recent days, there has been some pushback by central banks on market expectations around the magnitude and timing of rate cuts, given that official inflation remains above price stability goals. Nonetheless, once central banks begin rate cutting cycles there is often momentum, and the bond market, in addition to attempting to price the near term, is also trying to price the end point given higher-for-longer is no longer a consensus view. Mixed in with market pricing is also some probability ascribed to recession risks. Although central banks, like the Fed, endeavor to avoid generating recessions, it is challenging given that the transmission of policy has long and variable lags.

Given the uncertainty associated with the timing of policy rate cuts, volatility remains elevated. An additional element emanates from the supply side. Following the pandemic, governments have been left with significant debt loads and large deficits. The size of deficits at present is unprecedented outside of a recession. By virtue of these fiscal dynamics and the fact that central banks are reducing their stock of government bonds, there is significant bond supply coming to the market and required to be absorbed by the private sector. In October last year we observed a pickup in term premium as the market began to focus on this supply backdrop. Historically, a widening of fiscal deficits has coincided with a deteriorating economic backdrop and hence a pickup in demand for high quality bonds. With rate cuts coming back onto the agenda, this has trumped these technicals for now. Our preferred approach is to take exposure in the 1-10yr part of the curve, which has a stronger link to growth, inflation and policy, rather than the ultra-long end of the curve, which is more sensitive to these technical elements. We have gained some comfort in recent days with Fed speakers beginning to discuss the conditions necessary to slow the pace of balance sheet runoff ("QT"). This would alleviate the need for the private sector to absorb the net additional supply and a sharp run-down of excess reserves which could generate instability in the banking system.

Within the fixed income asset class, we are maintaining an up-in-quality bias expressed through high grade (HG) and investment grade bonds (IG). There are select opportunities in the more growth-sensitive areas of high yield (HY) and emerging markets (EM). However, we are cognizant that tighter lending standards operate with a lag on fundamentals, and current slower global growth and earnings in developed economies suggest higher default risk in the future. Additionally, liquidity risk premiums are prone to rising over time as global money supply shrinks. As a result, we see HY and EM spreads as being more vulnerable to spread widening relative to IG and HG.

High grade bonds: We maintain our most preferred recommendation on HG bonds. Inflationary pressures are abating and as a result, major central banks are now in discussions on when rate cuts may be appropriate. This is a favorable backdrop for duration risk. To see structurally higher interest rates across the curve from here, we believe economic growth needs to step up. As excess savings have been run down and fiscal policy is already loose, we see growth more likely to slow than accelerate going forward. High grade bonds are rated AA- or better, and therefore have minimal default risk. Given that the outright level of rates is high due to high policy rates, we see an attractive asymmetric absolute return profile in light of the inflation and growth mix.

Preference: Most preferred

CIO themes

Resilient credits

Resilient credits offer a decent income, following a sharp rise in interest rates and credit spreads. Our selection of tenors around five to seven years offers additional potential outperformance over riskier bonds (and stocks) in case of a recession, where interest rates would likely decline materially, while risk premiums of resilient credits would only rise moderately. Investors concerned about recession risk should consider this positioning over shorter-dated bonds with higher credit risk.

Analysts: Frederick Mellors

Bonds

Investment grade bonds: Like HG bonds, we maintain the asset class at most preferred. Last year total returns were high single digit. Looking ahead, given already full policy rate cut expectations, we see returns more in the mid-single-digit range. Within EUR IG, the average yield is around 4%. On US IG, yields for all maturity and intermediate profiles are around 5%. Credit fundamentals on the US IG corporate side remain solid and should provide protection in a slowing earnings environment. Any widening of spreads should be more than offset by falling interest rates as the focus turns toward rate cuts.

High yield bonds: We are neutral on the asset class as, relative to the higher-quality segments, we see more pronounced risks of spread widening and decompression as the tightening of financial conditions translates into higher corporate defaults for the more leveraged, growth-sensitive cyclical companies. As liquidity tightens, credit risk premiums should also widen. That said, the fundamental backdrop in HY is arguably not too bad. There has only been a limited amount of time since the last downturn, so we have not had the classic buildup of financial excess or leverage seen in previous cycles. In fact, the average credit quality in HY has improved. Additionally, the outright level of yields in US HY and EU HY is around 8% and 6.7%, respectively, which has attracted capital flows more recently and supported performance, hence our neutral stance.

Emerging market bonds: We maintain a neutral stance on the asset class. We think EM bonds can deliver high-single-digit returns in 2024, not least thanks to the elevated yield level. Current yields are around 8% and 7% for sovereign and corporate bonds, respectively. High nominal yields and prospects for a weaker US dollar and US policy rate cuts should support the asset class. But following the strong rally in late 2023, the room for error is small with spreads at the tight end of their historical range, leaving the asset class vulnerable to temporary setbacks. These could occur due to various reasons, including the risks arising from negative growth and inflation shocks; escalating geopolitical tensions; or rising defaults, whether in developing or developed markets, triggering a flight to safety.

FX

Price action over the holiday season suggests that EURUSD is likely to stay in a 1.05 to 1.10 range. The USD fell on a broad basis in the last days of last year due to position adjustments and rising Fed rate cut expectations. As fundamental investors tend to be quite long USD, any change in the outlook tends to lead to a stronger reaction in the USD than in other currencies.

But the situation seems to have normalized, with most G10 currency rates back in familiar ranges. We expect all central banks to start their cutting cycle in 2Q and major central banks to cut by a similar extent. We also expect inflation to fall further toward target ranges and growth rates to consolidate below trend growth without a major recession in any G10 country. This combination should lead to an extended period of range-trading in major FX rates.

The EUR had a short rally versus the USD at the end of the year, but we don't anticipate a major follow through. For this, global growth would have to be much stronger. Also, the political burden of the war in Ukraine, the conflict in Israel, and other geopolitical worries weigh more on the euro than the USD.

The GBP has had a similar development as the EUR. It enjoyed a strong rally versus the USD at times, but it has since consolidated. Also, the GBP would need a stronger global growth backdrop and a more stable geopolitical outlook to rally well beyond GBPUSD 1.30, in our view.

The Swiss franc strengthened late last year due the Swiss National Bank's policy of keeping interest rates low while selling FX reserves, which strengthened the currency and kept inflation low. In recent statements, the SNB turned softer on inflation fighting and signaled an end to selling currency reserves. Consequently, the CHF topped out and is now on a slow, cautious depreciation path, in our view.

For USDJPY, the near-term risk has become more balanced after the pairing fell from nearly 152 in mid-November to around 145–146 currently. On one hand, US-Japan yield differentials imply that USDJPY could still fall toward the 141–142 level. But on the other, we see room for a near-term USD rebound, considering current market expectations for Fed rate cuts look very aggressive to us. Overall, we favor selling USDJPY on rallies toward 147–148 levels, or selling upside risk above these levels for yield pickup.

For the CAD, NOK, AUD, and NZD, we see room for relative outperformance in the crosses. The AUD is likely to profit from the Reserve Bank of Australia joining the rate cut cycle only in 4Q due to stronger domestic economy. The pullback in oil prices should be transitory, which may support the CAD and NOK. We expect EURCAD to move lower and the NOK to outperform the SEK again.

2024 looks set to combine a global backdrop of moderate growth, falling inflation, and easing monetary conditions with emerging markets in a sound enough position for their currencies to benefit from moderate US weakness and still-elevated yields. Positioning in high-carry currencies has built up over the past months, and the current market pricing for Federal Reserve cuts seems too aggressive, in our view. We are looking for opportunities to engage with carry in emerging market currencies, but especially against the US dollar, we are careful currently given the market positioning. In the meantime, we recommend to make use of yield-enhancement opportunities, with a preference for the USDZAR pairing. We also recommend investors to buy the Turkish lira against the US dollar, as we expect the current policy direction to mitigate Türkiye’s vulnerabilities and the high interest rate carry to more than compensate investors for the continued depreciation of the lira. Emerging market currencies remain exposed to more hawkish-than-expected Fed policy, which could lead to a global growth slump, geopolitical flashpoints, and impacted commodity markets and risk sentiment, as well as idiosyncratic risks for individual currencies stemming from the monetary policy, fiscal policy, and politics.

FX

For China, we raised our USDCNY targets to 7.15 (from 7.10) for end-Sep 2024 and 7.15 (from 7.0) for end-Dec 2024, in light of weakening Chinese growth momentum, which speaks for further easing measures. Our end-2024 forecast now shows a sideways profile for USDCNY, which reflects our view that the CNY will not benefit materially from medium-term USD weakness. In this context, we reiterate our view that investors should stay hedged with their CNY long exposure.

The biggest risk to our short-term USD view is a rapid fall in US growth, which would put investor focus on structural USD negatives and the greenback's elevated valuation. The speed at which the US economy slows matters. If the US economy doesn't slow because consumer demand or fiscal spending comes in strong ahead of the US elections, current market expectations for lower US rates could still be revised higher.

Conversely, a hard landing, with risk assets under downward pressure, could temporarily support the USD. The USD tends to perform positively in a risk-off environment—in particular given the USD's depreciation of the last 24 months. Still, a hard landing would likely lead to a strong reaction by the Fed. Therefore, we think any major USD rally could be sharp initially, but would be watered down eventually by expansive central bank action.

Lastly, we are also watching the US bond market at the long end of the yield curve. The US fiscal deficit seems to be too high without the market commanding a higher term premium. A further rise in the 10-year US Treasury yield north of 5% could keep the USD on a path of further strength. That being said, it will also reach a point where higher rates provide little support for the currency as investors begin to worry about the economic knockdown effect at a later stage. However, we have yet to see this point emerging for the US economy and the USD.

Commodities

Subdued global economic growth forecasts for this year warrant a more benign return outlook for commodities overall. But structural factors are still in place, such as the commitment to sharply grow renewable energy supply, giving the asset class an additional demand cushion—beyond the cyclical growth aspects—in key commodities. In 2023, monetary policy tightening (i.e., interest rates hikes) played a more subordinate role for the asset class, except for precious metals. This year, the speed of policy easing (i.e., interest rate cuts) should in focus as a soft landing or even a manufacturing recovery in the latter part of the year largely hinges on this. The good news is that commodity markets, excluding precious metals, currently do not really appear to have factored in lower interest rates ahead, unlike equities. This should help to diversify portfolio returns.

Commodity-specific drivers on the supply side range from simple technical supply challenges to weather-related risks to geopolitical considerations. We think this favors energy in the short run, followed by precious metals around the first rate cut and industrial metals at a later stage. The focus in agriculture and livestock should be tilted toward livestock due to likely dwindling supply availability around midyear. Given the nature of El Niño, the agriculture sector requires investors to look for individual commodity picks. The underlying risk skew to our positive view appears largely balanced. Moreover, investor positioning in commodities is generally light, making potential downward moves limited.

Where to invest

Opportunities in longer-dated oil contracts. Longer-dated oil contracts are trading cheaper than spot prices. While commodity markets tend to price in the "now," futures curves, as a rule, don't hold much predictive power. So, vanishing available spare capacity should support longer-dated contracts, in our view.

Gold still a good hedge. We continue to recommend investors to use gold as a hedge despite being neutral in our global strategy. Within a balanced USD portfolio, our analysis shows exposure of a mid-single-digit percentage or so is optimal.

Volatility-selling strategies. On an individual commodity level, we see opportunities to engage in selling the downside in crude oil, platinum, and silver.

Analysts:Dominic Schnider, Giovanni Staunovo, Wayne Gordon

Section 3.2

Details per asset class

UBS

Eurozone equities

Central scenario

DJ Euro Stoxx 50 December 2024 target: 4,700

We maintain our neutral stance on Eurozone equities. While the economic slowdown and softer prices may slow the earnings recovery, the likely lower interest rates should allow for further modest price-to-earnings (P/E) multiple expansion from still relatively depressed levels.

After the equity market rebound, overall equity returns should be more modest. Eurozone (MSCI EMU) equity valuations, at 12.3x forward P/E (average since 1988 is 13.4x), remain reasonable, in our view, and already reflect the subtrend economic growth outlook and elevated interest rates. In our base case, we only see a modest further rerating from here in the absence of either a better economic outlook or faster-than-expected rate cuts.

We believe corporate profits are already in recession, especially in real terms. Rising prices over the last two years masked the underlying weakness in volumes and profit margins, which we think bottomed in 2023. Goods rather than services matter more for listed company earnings, and this part of the economy has arguably been in recession for some time. We think earnings can recover from here, helped by lower costs and bottoming volumes, but any recovery is likely to be slow given weak economic growth and softening prices. After almost no earnings growth in 2023, we forecast 3% earnings growth in 2024 (consensus 5%) and 4% in 2025 (consensus 9%).

We favor beneficiaries of disinflation, interest rate cuts, and bottoming manufacturing activity, where valuations are attractive. We expect consumer sentiment to improve as real incomes turn positive and rate hikes end, boosting consumer sectors. Eurozone small- and mid-caps should benefit from easing credit conditions and bottoming activity, with relative valuations at 20-year lows. The materials sector also offers attractive relative value with potential upside from bottoming manufacturing activity and the end of destocking.

CIO themes

Eurozone small- and mid-caps

We see attractive value in small and midsize companies, and believe that supportive inflections are starting to emerge in the macroeconomic backdrop.

Consumer recovery

We like European consumer stocks that are poised to benefit from an improving consumer outlook as real household income growth turns positive, inflation pressures ease, and central banks stop hiking.

Greentech goes global

This theme recommends companies that will likely play a key role in the global energy transition.

Eurozone equities

Upside scenario

DJ Euro Stoxx 50 December 2024 target: 5,200

Inflation falls quickly, allowing central banks to ease policy at a faster pace, supporting valuations that have been under pressure from higher discount rates.

The economy recovers. In this scenario, earnings could surprise to the upside if US and European economic growth is better than expected or China's economic outlook brightens.

Companies keep pricing power. If companies can maintain pricing power, margins could expand more than we expect and revenues could stay resilient, leading to upside risks to our earnings forecasts.

Lower European gas prices given that European gas storage is currently close to full capacity.

Downside scenario

DJ Euro Stoxx 50 December 2024 target: 3,800

Growth disappoints, potentially driven by a US recession, triggering weaker earnings growth and lower valuation multiples in anticipation of it.

Inflation starts to turn back up, which could mean rates stay at high levels, weighing on valuations and raising the risk of a deeper growth downturn in the future.

Political risks or other unforeseen consequences of higher yields emerge at a fragile time given high government debt levels and the reliance of some economies on disbursements from the EU recovery fund.

Gas concerns reemerge. Unforeseen disruptions to gas supplies, in combination with a cold winter or tight liquefied natural gas supply, raise the risk of production stoppages during winter.

Sector Preferences:

Most preferred: Consumer discretionary, consumer staples, and materials

Least preferred: communication services, healthcare, and industrials.

US equities

Central scenario

S&P 500 December 2024 target: 5,000

US economic data has continued to be healthy. The labor market is cooling, but initial claims for unemployment insurance remain low, jobs continue to be added in the most cyclical segments of the labor market (manufacturing and construction), there are still 1.4 open jobs for every unemployed worker, and real wages are rising. Early indications are that holiday spending was in line with expectations. At the same time, inflation has continued to improve. The six-month annualized change in the headline and core personal consumption expenditures price indexes are already back to the Federal Reserve's 2% target. As a result, the Fed is now indicating that rate cuts will be appropriate in 2024, and financial conditions have eased. We expect four Fed rate cuts in 2024.

Said another way, the US economy continues to have good momentum that should sustain growth in the coming months, and the prospect for Fed rate cuts will help extend the momentum. As a result, we have greater confidence in our expectations for a US economic soft-landing. This should lead to a pickup in earnings growth in 2024, especially as the headwinds in the goods side of the economy continue to diminish. Our S&P 500 EPS estimates are USD 240 (+8% year-over-year) in 2024 and USD 255 (+6% year-over-year) for 2025. Fourth-quarter earnings season is just beginning, but so far indications are that consumer spending remains healthy and guidance has been mostly supportive. We look for 4–5% EPS growth in the quarter, the second quarter in a row of positive growth.

The coming end of the Fed's inflation battle also means that the central bank can have greater confidence about cutting interest rates if growth falters. So, for the first time in a couple of years, investors can take comfort that Fed policy could be more of a tailwind, rather than a headwind. This should mitigate the size of any potential equity market sell-offs.

All that being said, we think the good news is already largely reflected in markets. As a result, we reiterate our neutral allocation on US equities. After the strong market gains in the final months of 2023, stocks could enter a period of consolidation, and it is certainly possible that investors will have better opportunities to add to their equity exposure. Our S&P 500 price targets are 4,900 for June and 5,000 for December. Valuation multiples are high (forward P/E of about 19.5x) but appropriate in our view given the favorable mix of durable growth, inflation that is essentially back at the Fed's target, and an expected improvement in manufacturing sentiment. Our main message is that investors should stay the course and be prepared to potentially increase exposure on pullbacks.

Sector preferences

Most preferred

- Consumer staples: While this defensive sector has lagged as the soft-landing scenario has become a consensus view, we think it's prudent to have some protection strategy in the portfolio in the event of a hard landing. The sector trades at a discount to the market, which we believe is attractive in the context of the sector's defensive growth profile.
- Energy: Oil prices have been under pressure due to higher-than-expected production growth. But growth looks set to ease in 2024 as US drilling activity remains muted. We believe OPEC+ supply cuts will remain in place until markets are in better balance. In this scenario, oil prices have scope to rise, which would benefit the sector. Valuations are pricing in a somewhat cautious outlook, and the sector should act as a cheap hedge for any unexpected increase in inflation or geopolitical tensions.
- Information technology: The sector should benefit from a bottoming in PC and smartphone end-markets. AI enthusiasm has cooled (leading to better valuations), and we think there is still upside to consensus estimates. Investors will likely continue to gravitate to high-quality companies that have good secular growth.

US equities

Upside scenario

S&P 500 December 2024 target: 5,300

Artificial intelligence is a game-changer: The impact of artificial intelligence on productivity and earnings growth is larger and comes sooner than investor expectations.

Stronger-than-expected economic growth: High wages attract even more workers into the labor force, and demand for labor stays strong. Real incomes continue to grow, and household cash cushions remain.

Inflation cools quickly: Inflationary pressures dissipate faster than expected, and the Fed cuts rates even more than we expect. This lifts expectations for economic growth and corporate earnings.

Downside scenario

S&P 500 December 2024 target: 3,700

Recession: The US slips into a full-blown recession in the next 6–12 months, primarily driven by the lagged effects of Fed rate hikes and as household cash cushions dwindle.

Inflation stays hot: Inflation pressures reaccelerate. Central banks are forced to raise interest rates even more or keep them at lofty levels for longer than expected. Stagflation risks increase as wage-price spirals start to form.

Geopolitical turmoil: Geopolitical flashpoints spiral further out of control, potentially disrupting energy supplies or dragging more countries into hostilities.

Sector preferences

Least preferred

- Real estate: The sector seems to be pricing in lower interest rates. Estimates are still high in some areas that over-earned during the pandemic. Growth in adjusted funds from operations will likely lag S&P 500 profit growth.
- Utilities: Increased regulatory risks and resilient economic data may lead to underperformance. We prefer to have defensive exposure through consumer staples, which continues to exhibit pricing power and benefits from resilient consumer spending.

UK equities

Preference: Least preferred

Central scenario

FTSE 100 December 2024 target: 7,900

We expect the global economy to slow further, as developed market economies continue to absorb the impact of monetary tightening. Due to the expected year-over-year changes in underlying commodity prices, we believe the energy and mining sectors will see negative earnings growth this year, as will consumer discretionary given the pressure on the consumer from inflation and interest rates. During 2024, earnings should start to recover as the drag from commodities fades. However, bank earnings should fade as interest rates peak. As a result, the UK's overall earnings growth profile is weaker than that of other markets, and we anticipate better earnings revisions elsewhere. Therefore, while we see absolute upside to the FTSE 100 over the next 6–12 months, we believe it will likely underperform other equity markets.

While the UK equity market looks attractively valued, valuation is not normally a driver in the short term, but earnings momentum is. The FTSE 100 trades on a 12-month forward price-to-earnings (P/E) multiple of 10.4x—around 15–20% below its long-run average—and more than a third lower than global equities (MSCI All Country World Index). However, this is a reflection of its composition, consisting mostly of value sectors such as financials, energy, and commodities. We see the 4% dividend yield of the UK market as attractive in the context of moderate expected capital appreciation.

Upside scenario

FTSE 100 December 2024 target: 8,400

Valuations rerate: A reduction of the UK's discount versus global equities offers upside risk to valuations.

Higher commodity prices: Higher commodity prices, especially oil, could provide additional upside to FTSE 100 earnings, especially relative to other regions.

Better global growth: If global economic growth is better than expected, this could support higher earnings than we currently anticipate and boost equity valuations.

Downside scenario

FTSE 100 December 2024 target: 6,000

Lower oil prices: If the price of Brent crude oil falls, earnings growth could be hurt as the energy sector contributes around 25% of FTSE 100 earnings.

Weaker economic growth: Should global economic growth slow more than anticipated, this would be negative for earnings and equity valuations.

Sticky inflation: Persistently high inflation could keep Bank of England rates higher for longer and put downward pressure on equity valuations and the economic growth outlook.

Stronger sterling: Sterling strength would be a drag on the FTSE 100, which generates close to 75% of its revenues outside the UK, although stronger sterling likely comes alongside a better economic growth backdrop.

Swiss equities

Central scenario

SMI December 2024 target: 11,640

After a strong 2021, we expect corporate profits to have dropped 7% over the 2021–23 period due to the global economic slowdown and significant currency losses. This year, we expect 7% earnings growth, supported by robust organic sales growth; margin improvements particularly in the healthcare, consumer staples, and financials sectors; cost-cutting measures; and more moderate currency losses. Although we are working on the basis of a significant economic slowdown, the greatest risk to our 2024 earnings expectations lies in an even weaker global economy than currently forecast. This would probably cause the Swiss franc to appreciate even more.

Since early June 2022, the Swiss National Bank (SNB) had increased its prime interest rate to mitigate inflation pressures despite a recent slowdown in Swiss and global growth. Higher CHF interest rates support the Swiss franc. This in turn has weighed on Swiss profits, of which 90% of are generated in foreign currencies. We expect negative currency effects to moderate significantly from 2Q24. Moreover, we currently forecast the SNB to begin cutting its prime rate in June 2024.

Swiss equity valuation multiples are modestly above their 25-year average, which we think is fair given normalized interest rates. Dividend yields remain attractive despite now higher bond yields, in our view. At 3.2%, the expected yield is above the 25-year average of 2.4%. We think the key drivers for Swiss stock prices from here will be companies showing robust profit improvement and, to a lesser degree, multiple expansion. Hence, stock selection is important.

With European and global economic growth prospects weakening, the defensive characteristics of the Swiss market look favorable compared to other equity markets. With regard to investment strategy, we recommend focusing on quality firms and service companies, and selectively on cyclicals and mid-caps. Companies with attractive and sustainable dividend and free cashflow yields are particularly appealing to us.

Key risks include protectionism, international trade disputes, a significant economic downturn, currency losses, and Swiss-EU negotiations.

Swiss equities

Upside scenario

SMI December 2024 target: 12,300

Robust Swiss profits: If there is only a modest global economic downturn ahead, corporate profits could expand by low teens in 2024.

Sustainable dividends: Swiss dividends have generally grown every year since 2009. In 2021, however, total SMI dividends fell by 3%. In 2022 and 2023, they recovered by 6% each. In our upside scenario, we would expect mid-single-digit percentage rises this year (i.e., for the business year 2023) and in 2025.

Manageable currency impact: In 2020, currency effects were clearly negative, while those in 2021 were insignificant. They then increased a bit in 2022 and significantly in 2023. In 2024, we expect currency losses to moderate.

Downside scenario

SMI December 2024 target: 9,800

Economic and political risks: Significant global economic risks, negative currency trends, and international political disputes are headwinds for a small country with above-average international exposure.

Valuations: While dividend yields are attractive, corporate profits may be flat in 2024, leaving the SMI trading at an unjustified premium to its 25-year forward P/E average.

Sector composition: The SMI has a high exposure to defensive industries and quality companies that tend to underperform when bond yields increase strongly or economic growth expands.

Emerging market equities

Preference: Most preferred

Central scenario

MSCI EM December 2024 target: 1,080

We view emerging market (EM) equities as most preferred. The macroeconomic picture in emerging markets remains healthy, though momentum has slowed. Aggregate manufacturing PMIs continue to be in expansion territory, economic surprises have been positive, and inflation continues to normalize. In our view, emerging market companies look set to deliver solid mid-teens earnings growth in 2024.

Valuations for the MSCI EM index are largely in line with their 10-year average, yet still stand at an above-average discount to US stocks. In our view, this gap does not factor in the better earnings growth prospects we see for emerging markets relative to global peers this year.

A strong US dollar, sharply higher US rates, an uptick in geopolitical tensions, a pronounced US recession, and growth disappointments in China are risks to the outlook for EM equities.

From a geographic standpoint, China remains most preferred. We think markets have priced in a lot of the negatives around both cyclical slowdown and structural issues in China. In the meantime, policy support will likely continue, and, if it surprises to upside, should bode well for rerating. We also keep India as most preferred. We believe India's valuations are reasonable, while the corporate outlook looks healthy. Last but not least, we are upgrading Indonesia to most preferred as we expect domestic drivers to take the driver's seat, with US real yields likely having peaked.

From a thematic angle, we like environmental, social, and governance (ESG) leaders in emerging markets, which can help mitigate downside risks and present attractive valuations, in our view. For investors with a multiyear time horizon, we recommend exposure to three thematic opportunities: frontier markets, emerging market infrastructure, and emerging market healthcare.

Upside scenario

MSCI EM December 2024 target: 1,200

Sizable GDP growth recovery: A continued economic recovery would benefit corporate earnings and lift valuation multiples.

Global monetary policy: A less hawkish policy stance would bring about a more benign external environment.

China policy support: Stronger-than-expected policy easing and faster demand recovery in China would support emerging market stocks.

Downside scenario

MSCI EM December 2024 target: 820

Global GDP growth fears: Persistently high inflation could force central banks to tighten more aggressively, sending economies into a deep recession.

US dollar strength: Emerging market stocks typically suffer in a strong US dollar environment.

Geopolitics: A further deterioration in US-China relations and the war in Ukraine would hurt emerging market assets.

CIO themes

ESG matters in emerging markets

This theme offers investors an opportunity to add value to their portfolios by incorporating ESG considerations into their investment decisions. The wide disparity in ESG performance among emerging market companies tells us investors should focus on those with strong management to reduce the risk of tail-risk events, particularly in relation to governance (e.g., accounting and audit issues) as well as severe environmental accidents.

Market preferences

Most preferred

China, India, Indonesia (new)

Least preferred

Singapore, Malaysia (new)

Japanese equities

Central scenario

TOPIX December 2024 target: 2,620

We are neutral on Japanese equities in our global portfolio. The TOPIX's 6% growth YTD has outperformed MSCI ACWI. This year's rally seems driven by yen weakening, after a sharp appreciation in December, and by investors buying large-cap stocks. These large-caps have outperformed the TOPIX by 2–5 percentage points YTD. We expect further mid-single-digit upside in the very near term, as long as strong index purchasing inflows from international investors continues—similar to early 2023.

Moreover, the domestic macro outlook remains favorable, with moderate inflation and wage growth, and solid earnings as we forecast corporate earnings growth of 9% for FY23 (end-March 2024) and 7% for FY24, based on a mild strengthening of the yen this year. However, valuations are approaching last year's peak. Japanese equities' forward P/E has risen to 15.1x versus 14.4x at the start of the year, and is above the historical average of 13.7x. We believe after 4Q results (December quarter) are announced in the next few weeks, the focus will shift to fundamentals and quality. Going forward, we think stock selection will be important.

So, we advise focusing on quality—including banks and real estate, but also adding laggard growth. While both banks and real estate have lagged this year's rally due to the expected Bank of Japan (BoJ) monetary policy normalization being pushed back amid the Noto Peninsula earthquake earlier this month, this catalyst should still materialize sometime in 1H, in our view. Bank stock valuations, with a P/B of 0.7x, are still below pre-2016 levels, while higher Japanese government bond (JGB) yields support earnings growth, and their dividend yield of 3.5–4% is attractive in our view. We also like laggard growth stocks with an above-market-average earnings growth outlook in FY24, as US 10-year yields appear to have peaked. We prefer companies with high domestic exposure that have underperformed against the benchmark over the past two years.

Upside scenario

TOPIX December 2024 target: 2,700

Higher ROE: Potential business portfolio restructuring or increased investment to increase return on equity (an aim of the Tokyo Stock Exchange) and profit margins become a rerating catalyst for Japanese equities in the longer term.

Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy lead to stronger topline growth for Japanese corporate earnings.

Sustainable inflation and wage growth: Solid 2024 Shunto wage negotiations results provide confidence to investors that Japan's moderate wage growth and inflation could be sustained in 2024, and that there could be structural changes in the economy.

Downside scenario

TOPIX December 2024 target: 2,000

Recession: The US slips into a recession, and increased tensions between the US and China put downward pressure on Japan's economic and earnings growth outlook.

Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy lead to stronger topline growth for Japanese corporate earnings.Global economic growth remains resilient: A strong Chinese economic recovery and a resilient US economy lead to stronger topline growth for Japanese corporate earnings.

US inflation remains elevated: Inflation stays hot and the Federal Reserve is forced to raise interest rates even more than expected or keep them high for longer than expected, leading to a correction in valuations.

Asian ex-Japan equities

Central scenario

MSCI Asia ex-Japan December 2024 target: 685

Inflation in Asia has been trending lower and steadily moving back toward central banks' comfort zones, and we expect Asia's central banks to cut in 2H24, following the Fed. With the help from recovering global orders, growth in Asia is returning to trend. Advanced Asia like Singapore has had a solid start to the year, and emerging Asia should catch up in the second half. PMIs, on the other hand, are mixed, with no decisive trend yet. As a result, we believe it is still too early for a directional trend in the equity market to form. We remain focused on relative opportunities within the region. We keep most preferred views on China and India, and keep a least preferred view on Singapore. Given the receding risk of unusually high US real yields and given the macro and fundamental environment in the region, we are upgrading Indonesia to most preferred and downgrading Malaysia to least preferred.

We are upgrading Indonesia given the supportive macro and fundamental backdrop. MSCI Indonesia is 60% financials, which should benefit from high net interest margins and healthy loan growth in the country. Earnings has been in a steady uptrend, with its P/B valuation at 0.5 standard deviation below 5-year average. From a macro perspective, Indonesia has a strong economy, with its PMI consistently above 50. The high policy rate of 6% provides plenty of room for cuts, given CPI in the country is low at 2.6% and FX reserves are healthy. The upcoming election is a key risk to monitor, while recent polls show policy status quo as the most likely scenario. The resurgence of US real yields to such high levels is another risk to watch. But we believe potential upside for the Indonesia market outweighs the risks at this point in time. On the other hand, Malaysia has a weak macro environment, with its PMI which consistently below 50; manufacturing exports are decent but not strong. With relatively weak balance of payments and a relatively low policy rate of 3%, we see only limited room for rate cuts. Fundamentally, 40% of the market is financials, which are expecting net interest margins of just 1.87% to 2.26% in 2024. As a result, despite the cheap valuation of the market, with a P/B at 1.8 standard deviation below the 5-year average, we believe the market's near-term upside is limited.

Elsewhere, we keep China as most preferred. We acknowledge that policy tones from the Central Economic Work Conference (CEWC) held in December were more muted than expected. Also, some latest released macro data from business surveys, credit, and inflation have not yet shown signs of a strong recovery. But we believe that sustained policy support will continue, particularly now is just 6–8 weeks away from the "Two Sessions" in March. Given the current valuation is cheap (forward P/E at 1.3 std below 5-year average) and global hedge funds' allocation to China is at a 5-year low, the downside of the equity market is likely limited. In our base case, we forecast double-digit returns for the market. We see opportunities in sectors that are high-quality and long-term winners . In the upside case of more aggressive expansion policy, we would expect a rapid lift across the whole market.

For India, its macro backdrop remains solid. Domestically, GDP growth has been strong, and its PMI has consistently been above 50. Externally, the country's FX reserves are big and increasing, and its balance of payments situation doesn't seem to be a headwind for the INR. Since inflation is still high at 5.6%, we don't expect policy rate cuts will be imminent in 1H24; we expect the 6.5% policy rate will be lowered to 6% by the end of next year. The general election in April will be a risk to watch, particularly with the valuation of the market slightly expensive with a forward P/E at 0.9 standard deviation above the 5-year average. But for now, with its robust earnings trend and strong macro environment, we maintain our most preferred view on the market.

Market preferences

Most preferred: India, China, Indonesia (new)

Least preferred: Singapore, Malaysia (new)

Asian ex-Japan equities

On the other hand, we keep Singapore as least preferred. Singapore's economy is recovering, but fundamentals continue to face headwinds. Half of the market is financials, which should see falling net interest margins in 2024. Earnings have been trending down steadily, and valuations aren't particularly cheap, with its P/B 0.3 standard deviation above 5-year average. Despite weak domestic activity, recovering global activity should provide some lift to the economy. Hence, until we see upside catalysts, we keep Singapore at least preferred.

Upside scenario

MSCI Asia ex-Japan December 2024 target: 741

Fed starts rate cuts earlier than expected

Asian equities are likely to rebound strongly if the Fed starts to cut rates or stops quantitative tightening, especially if the economic slowdown is less severe than feared and inflation drops faster than expected.

Strong Chinese housing demand recovery

A meaningful recovery in property investment in China is likely to push Asian equity markets higher given the subdued expectations on this front.

Strong demand recovery in tech

If we see a faster-than-expected final demand pickup in this space, it could lift the Asian market as a whole since tech is a key component of MSCI Asia ex-Japan.

Downside scenario

MSCI Asia ex-Japan December 2024 target: 493

Sharp slowdown in DM growth

If US/Europe growth turns out to be much worse than our mild recession assumptions, Asian equities could be impacted.

Re-escalation in Sino-US tensions

Risk sentiment would likely weaken if the US adds secondary sanctions on Chinese firms or financial institutions.

Stronger US dollar

Asia-ex-Japan regional equities usually suffer in a strong US dollar environment.

High grade

Preference: Most preferred

Central scenario

10-year US Treasury yield December 2024 target: 3.50%

With indications that inflationary pressures continue to abate, major central banks have ended their rate hikes and are assessing when it may be appropriate to ease policy. Against this backdrop, we continue to like high grade bonds. Our rationale is that central banks have succeeded in ensuring inflation expectations remain stable and although much is already priced into curves in terms of rate cut expectations, there is often downward momentum on term rates once central banks start rate cutting. Additionally, although there are high expectations that the US can avoid a recession, the lagged transmission of all the policy rate tightening over the last two years continues to present downside risks to growth and financial stability. Interest rate volatility is likely to remain elevated, particularly in the long end of the curve, as government bond supply is large given existing deficits and maturity profiles. Accordingly, our preferred approach is to take rate risk in the 1–10yr part of the curve where the link to growth, inflation, and policy is stronger, as opposed to the ultra-long end of the curve, which has sensitivity to technical dynamics.

Upside scenario

10-year US Treasury yield December 2024 target: 2.50%

In the upside scenario for high grade bonds, growth falls sharply on a global scale toward mid-2024 owing to the delayed impact of monetary tightening or additional tightening efforts to tame persistent core inflation. Once demand for goods and services weakens, inflation drops quickly with energy prices falling and the labor market losing momentum. As recession kicks in, major central banks cut rates aggressively. Balance sheet runoff ends and QE restarts.

Downside scenario

10-year US Treasury yield December 2024 target: 4.00%

In the downside scenario for high grade bonds, US activity grows above its trend rate of 2% as labor markets and household balance sheets prove resilient to monetary policy tightening. Inflation continues to fall toward price targets, paving the way for central banks to trim policy rates down from currently restrictive levels.

Investment grade

Preference: Most preferred

Central scenario

December 2024 spread targets: 120bps (USD IG) / 150bps (EUR IG)

US dollar and euro investment grade spreads were little changed over the last month. While supply has strongly ramped up as per the typical January trend of higher issuance levels, this has so far has been well absorbed with indications of strong investor demand to meet the increased supply. We also note that the share of M&A-related issuance has remained low and use of proceeds for refinancing remains at above average levels, suggesting that use of proceeds remain creditor-friendly overall.

With yields remaining elevated and major central banks in developed markets likely having ended their hiking cycles, we think total return prospects in higher-quality fixed income remain appealing over the coming quarters. US investment grade (IG) yields are at 5% and EUR IG yields are at 3.7%. While these levels are off their recent peaks, they remain historically elevated. The elevated outright yields and the fact that spreads are a much smaller proportion of all-in yields than in the recent past are positives for forward-looking returns.

High-quality bonds tend to be resilient in a growth slowdown, as credit spread widening is usually offset to a good degree by falling interest rates. This was the case in March last year, when deteriorating risk sentiment related to concerns about the banking sector on both sides of the Atlantic caused IG spreads to widen. However, total returns were resilient as falling government bond yields more than offset the widening in credit spreads.

We still see prospects for lower government bond yields as economic growth slows, inflation continues to moderate, and markets look to price both the upcoming rate-cutting cycle as well as the expected longer-term neutral policy rate in the coming quarters, which should contribute to total returns for the asset class. US IG tends to do particularly well at the end of a Federal Reserve hiking cycle. We think the total returns outlook for US IG remains supported by expected lower government bond yields in our base case over the coming quarters and our outlook of relatively resilient spreads.

US IG fundamentals remain generally solid. Median net leverage (excluding financials and utilities) remained broadly stable at 2.0x in 3Q, and compares to 2.2x in 4Q19, just prior to the pandemic. The median interest coverage ratio has declined on rising interest expenses; however, as of 3Q, it was still at a solid level of 10.6x, compared to 10.4x in 4Q19. While we do expect nominal growth to slow, earnings are expected to be resilient in our base case and this would help limit material near-term credit quality deterioration, in our view. As such, while ratings migrations have become less supportive over time, they are not expected to turn significantly negative in our base case scenario. We also note that debt growth has remained very muted as issuers have continued to exhibit a conservative balance sheet management approach overall. We therefore view the risk of rising downgrades and upward pressure on spreads as limited outside a deep recession.

We continue to believe IG bonds stand to deliver attractive risk-adjusted returns, given all-in yields and the shifting balance between inflation risks and growth risks.

Investment grade

Preference: Most preferred

Upside scenario

Bloomberg Barclays US Int. Corp. December 2024 target: 80bps/ Bloomberg Barclays Euro-Agg. Corp. December 2024 target: 110bps

Goldilocks

Growth remains robust, inflation continues to decline, and the Fed cuts interest rates preemptively, with six rate cuts in 2024, potentially starting as early as March.

Downside scenario

Bloomberg Barclays US Int. Corp. December 2024 target: 200bps/ Bloomberg Barclays Euro-Agg. Corp. December 2024 target: 220bps

Hard landing

Growth falls sharply on a global scale toward mid-2024, owing to the delayed impact of monetary tightening or additional tightening efforts to tame persistently high core inflation.

High yield

Central scenario

December 2024 spread targets: 450bps (USD HY) / 450bps (EUR HY)

Valuations have significantly compressed amid declining near-term left-tail risks to the policy outlook given continued moderating inflation and a gradual cooling of the labor market, which supports the case for the Fed to begin cutting policy rates in the coming months.

At current valuations, US HY appears to be discounting a below-average default rate in the year ahead of 1–2% and a nominal growth rate in excess of 5%. Despite the improved policy outlook, we expect US nominal growth rate to slow as the lagged effect of all the policy tightening continues to work its way through the system. While less tight than in the prior quarter, lending standards remain historically tight, pointing to some downside risks to growth and upside risks to defaults over the coming 12 months. Additionally, while further rate hikes look unlikely at this stage, scope for significant rate cuts in the magnitude currently implied by the market look aggressive, in the absence of signs of a more significant slowdown in growth, given what still appears to be relatively tight labor markets, in our view.

Many companies were fortunate to lock in lower funding costs prior to the sharp moves higher in rates. Over time, this benefit diminishes as maturities approach and refinancing needs increase. This, coupled with a potentially more challenging earnings backdrop as growth slows, are headwinds for lower-rated credit. Lower-rated issuers are at particular risk if rates remain high for longer given the large associated step up in interest expenses. Such issuers could struggle to meet their refinancing needs. Indeed, while primary markets appear to be open for many HY issuers, this is mainly for those in the upper rating buckets for now. We estimate corporate defaults this year could remain at levels of around 4% (on an issuer-weighted basis), which is above what credit spreads appear to be implying.

However, we still view the risk of a sharp rise in defaults as low. We have not seen the classic buildup of financial excess and leverage since the last default cycle in 2020 related to the COVID-19 pandemic, which gives some comfort. Leverage remains low, although it has been trending higher as earnings growth has declined and debt levels have ticked up. The energy sector in the US, which has historically been a source of defaults in downturns, is in a relatively healthy state having deleveraged since the last default cycle.

Currently, the level of credit risk premium is not overly cheap, in our view. This is the compensation credit investors require over and above expected credit losses. One explanation for this is the fact that the market has shrunk from USD 1.5tr in 2021 to USD 1.3tr. This is due to net rising stars (issuers upgraded to investment grade and therefore leaving the high yield universe), while net issuance has remained low. These favorable technicals are likely to slowly diminish over time, as net issuance increases due to issuers addressing their maturity walls while the scope for further net rising stars has diminished. While inflation has continued to move lower, the market may be overestimating the amount of rate cuts that will be delivered this year (in the absence of a recession or systemic crisis). At the same time, central banks have shown a willingness to actively use their balance sheets temporarily when market conditions turn dysfunctional, and we also note that the last Fed minutes indicate discussions around reducing the pace of QT are likely to increasingly come into focus.

We remain neutral on HY bonds. Although we forecast scope for moderately wider spreads in HY in the coming quarters, the current level of outright yields in US HY remains historically elevated at around 8% at an index level. This is important as the high yield market generates significant carry with every passing day. The higher level of rates provides a sizable buffer against mark-to-market losses that could occur from potential widening in credit spreads.

High yield

Upside scenario

ICE BofA US high yield spread December 2024 target: 370bps / ICE BofA Euro high yield spread December 2024 target: 370bps

Goldilocks

Growth remains robust, inflation continues to decline, and the Fed cuts interest rates preemptively, with six rate cuts in 2024, potentially starting as early as March.

Downside scenario

ICE BofA US high yield spread December 2024 target: 850bps / ICE BofA Euro high yield spread December 2024 target: 850bps

Hard landing

A slowdown in growth, possibly resulting from the cumulative effect of interest rate hikes so far, results in a moderate recession. The potential severity of this scenario would be mitigated by the easing in financial conditions so far and likely sharp interest rate cuts by the Fed in response.

Emerging market bonds

Central scenario

December 2024 spread targets: 425bps (EM sovereign bonds) / 350bps (EM corporate bonds)

After a strong end to 2023, EM bonds appear to be consolidating with yields ticking up in January amid a moderate widening in credit spreads and a rise in US Treasury yields. January typically sees a higher volume of credit supply, which can have a temporary impact on credit spreads. So far this year, issuance from EM IG sovereigns in USD has reached USD 24bn vs. USD18bn over the same period last year. However, we note this has been met by very strong demand.

We maintain a neutral stance on the asset class. We think EM bonds can deliver high-single digit returns in 2024, not least thanks to elevated yields. Current yields are around 8% and 7% for sovereign and corporate bonds, respectively. High nominal yields, the prospects of a weaker US dollar, and US policy rate cuts should support the asset class. Given the continued moderation in inflation, we expect the Fed to begin cutting policy rates in May, and our base case scenario is for four 25-basis-point rate cuts this year. While global growth is expected to slow, we still expect the US to avoid a recession this year.

But following the strong rally in late 2023, the room for error is small with spreads at the tight end of their historical range. This leaves the asset class vulnerable to temporary setbacks. These could occur due to various reasons, including negative growth and inflation shocks, escalating geopolitical tensions, or a flight to safety triggered by rising defaults in either developing or developed markets.

Current yields are around 8% and 7% for sovereign and corporate bonds, respectively, which remain elevated vs. history. We see emerging market fixed income exposure as desirable in global portfolios. We expect the returns on the asset class to be supported by sizable interest rate carry and an expected decline in US benchmark yields. Within the asset class, our preference is for a barbell approach that combines selecting shorter-duration, lower-rated names to benefit from high interest rate carry, along with higher quality longer-duration bonds to lock in future returns, while hedging against the risk of a recession and other potential negative events this year.

Upside scenario

EMBIG Diversified / CEMBI Diversified spread December 2024 targets: 340bps / 280bps

Goldilocks: China's economy recovers faster than expected as it opts for large-scale fiscal stimulus measures, coupled with a global economy that exhibits resilience to tighter financial conditions. Major central banks start cutting policy rates in early 2024 as inflation normalizes ahead of expectations, in order to avoid monetary policy becoming too restrictive in real terms.

Commodity price recovery: A further price appreciation in commodities improves the terms of trade for commodity-exposed issuers and strengthens fiscal positions.

Downside scenario

EMBIG Diversified / CEMBI Diversified spread December 2024 targets: 600bps / 550bps

Economic slump: A sharp global economic slowdown leads to weaker EM currencies, deteriorating credit quality due to fiscal vulnerabilities, and wider spreads.

Fed tightens again: Inflation remains higher for longer, and the Fed is forced to deliver further monetary policy tightening, slowing economic growth in the process.

Geopolitical tensions escalate: Heightened friction, emanating from either the war in Ukraine, the conflict in the Middle East of US-China relations, hurts risk sentiment, strengthening the US dollar and curbing appetite for EM assets.

Rising populism: Increased conflicts within and between countries could arise as populist policies become more widespread globally.

Asian bonds

Central scenario

JACI composite spread December 2024 target: 250bps

Government bonds have rallied strongly in the past few months, with the 10-year US yield falling by around 100bps from a 16-year high of 5% in last October to 3.98% as of 16 January. This yield movement reflects increasing optimism that falling inflation will allow the Federal Reserve to cut rates swiftly in 2024. We expect four 25bps cuts in 2024 and bonds yields to further fall (10yr US Treasury to 3.5% by year-end). Meanwhile, there could be some short-term setbacks given the speed of this rates movement, and rates volatility could remain at a high level. As a result, we continue to prefer high-quality segments, like high grade (HG) bonds and investment grade (IG) bonds, as it still makes sense to lock in current attractive yields. Also, their risk-reward would be more favorable if a sharper economic slowdown scenario happens.

Largely driven by rates, Asia credits also have had a strong performance in past few months. Within the region, we believe Asia IG bonds still present solid risk-reward potential. The current yield (5.5% as of 16 January) is slightly lower from last month but still attractive given the segment's high credit quality (average rating of A-). Valuation-wise, the current level is still tight (155bps as of 16 January), but we expect the spread level to be resilient given supportive technicals (e.g., negative net issuance) and stable fundamentals for most issuers. After Moody's put China on downgrade warning last December, further negative rating actions in China could be a potential risk to watch, given that China still accounts for a sizable portion of the IG index (38%).

For Asia high yield (HY) bonds, on the other hand, we remain cautious and maintain a selective approach. For China property, we continued to see some marginal policy support in the past month, e.g., the PBoC injected CNY 350bn of pledged supplementary lending facilities, which is widely expected to be used to fund urban village renovations and build affordable housing. There were also news reports on plans to create a whitelist of developers to extend some funding support. However, we don't expect China's property sector to turn around meaningfully soon, as fundamentals are still under pressure from falling property sales and prices. Elsewhere in Asia, issuers' fundamentals are relatively stable, including in Macau, India, Philippines, etc. We think there are some cherry-picking opportunities from a bottom-up perspective.

Upside scenario

JACI composite spread December 2024 target: 220bps

Much faster recovery after full reopening: If China's recovery is faster and stronger than expected in the coming months, Asia credits would likely see upside.

Sharp property rebound: Policy has been focused on demand-side measures so far, but the housing sales recovery remains uneven and mixed. A rebound in housing sales or more details on supporting developer liquidity needs would offer fundamental support to the credit metrics of this sector.

More dovish-than-expected central bank action: Spreads would likely compress if the Fed becomes more dovish than expected and less aggressive with quantitative tightening if inflation comes off faster than expected.

Downside scenario

JACI composite spread December 2024 target: 320bps

Much higher default rates: The HY sector may see a sell-off if default rates far exceed current market pricing.

Increased China-US tensions: Heightened friction emanating from upcoming US elections next year could hurt risk appetite for EM Asia assets.

Deep US/Europe recession: If the US or Europe fall into a deep recession, growth in Asia and sentiment toward Asian credit would be impacted.

Crude oil

Preference: Most preferred

Central scenario

Brent crude oil December 2024 target: USD 82/bbl

Oil demand growth will likely slow to 1.4mbpd, but that is still higher than the growth rate of 1.2mbpd seen since 2000. We also expect non-OPEC+ production growth to slow down to around 1.3mbpd. While this does not sound very positive, market sentiment is currently quite pessimistic—net length in Brent and WTI futures and options stands close to a record low.

Saudi Arabia and OPEC+ have indicated their desire to act as a central banker in the oil market in order to prevent large inventory buildups. This strategy is based on a proactive and preemptive approach in adjusting the group's output. While the latest voluntary production cuts are only in place for 1Q24, Saudi Energy Minister Prince Abdulaziz has already indicated that the return of those barrels will be gradual. Additionally, an extension of those cuts is a possibility, and is our base case. We expect the group to extend the cuts into 2Q24 and only gently add barrels back to the market in 2H24. The likely addition of barrels in 2H24 would also make it easier for the group to start from a higher production level if new cuts are required in 2025, in our view.

Upside scenario

Brent crude oil December 2024 target: USD 120–140/bbl

Upside risks to our forecasts include destabilizing political events in oil-producing regions such as Libya, Venezuela, Nigeria, and the Middle East, which could trigger a sharp drop in supply for a sustained period.

Downside scenario

Brent crude oil December 2024 target: USD 40–60/bbl

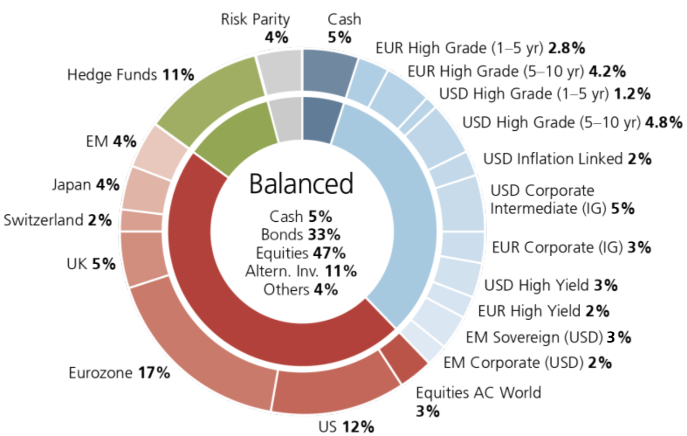
Downside risks include a deep recession or renewed extended mobility restrictions that weigh on the oil demand recovery. A hard landing for the Chinese economy in 2024 would also pose a downside risk. Another concern is that capital discipline in the US could start to erode, and an uncontrolled unwinding of OPEC+ production cuts could also present a potential downside risk.

Section 4

Appendix

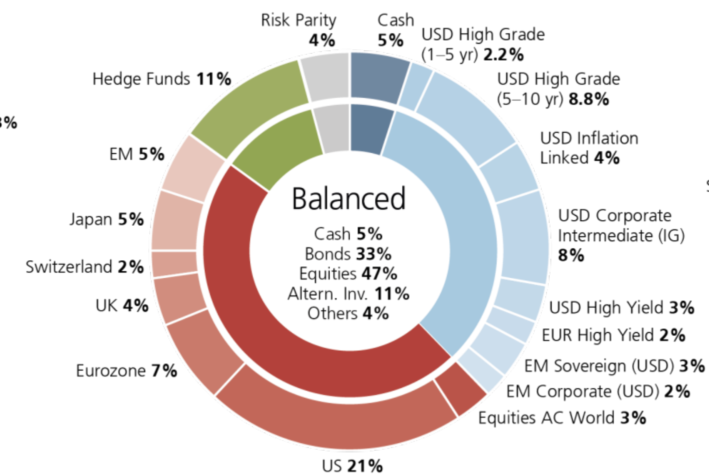
Strategic Asset Allocations (SAAs)

EUR (local portfolio)



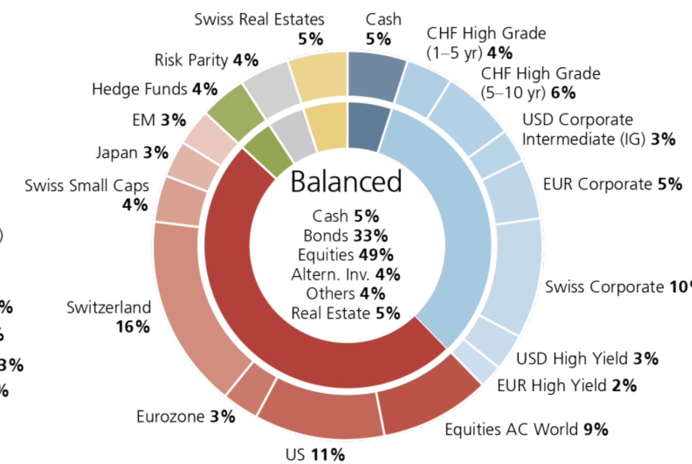
Note: Portfolio weightings are for EUR SAA with a home bias and a balanced risk profile. We expect a balanced EUR SAA to have an average total return of 5.7% p.a. and a volatility of 8.7% p.a. over the next 15 years.

USD



Note: Portfolio weightings are for a USD SAA with a balanced risk profile. We expect a balanced USD SAA to have an average total return of 6.4% p.a. and a volatility of 8.8% p.a. over the next 15 years.

CHF (local portfolio)



Note: Portfolio weightings are for CHF SAA with a home bias and a balanced risk profile. We expect a balanced CHF SAA to have an average total return of 4.9% p.a. and a volatility of 8.6% p.a. over the next 15 years.

Source: SAA as of January 2024

For illustrative purposes only. The above asset classes and allocations are indicative only and can be changed at any time at UBS's discretion without informing the client. All expected returns are p.a. and reflect the arithmetic mean of the estimated return distribution. Risk is measured as annualized volatility of monthly log-returns. Annualized expected risk and return figures are forward-looking and not a reliable indicator of future performance. Forecasts are not a reliable indicator of future performance / results. Please always read in conjunction with the glossary and the risk information at the end of the document.

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